

**STATE BOARD OF EQUALIZATION**

(916) 445-3237

January 16, 1985

J--- F. M---, Jr.  
---, --- & ---  
Accountancy Corporation  
XXX --- ---  
---, CA XXXXX

Re: S--- R--- & A---, Inc. – SP UT XX-XXXXXX

Trade-in of defective airplane

Dear Mr. M---:

In your letter to the board's occasional sales unit dated October 18, 1984, which was referred to the legal staff for reply, you write:

S--- R--- and A--- (SRA) acquired on July 13, 1983, a Beechcraft Baron Aircraft. This aircraft was new and purchased directly from the factory. The cost of the airplane was \$460,000. California use tax of 6% was paid on this aircraft. The aircraft has been used for corporate business since its purchase.

The corporation, in connection with maintenance activities, discovered in 1984 a factory defect in the construction of the aircraft. Specifically, the metal surfaces of the wings were sanded. This defect makes the aircraft unsafe and unsuitable for the corporation's use. The corporation has reached an agreement with the manufacturer that the aircraft can be returned. The manufacturer does not have in its inventory a 1982 Model Baron.

Beechcraft and SRA have agreed that a 1984 Baron be substituted for the defective 1982 Baron. The 1984 Baron was used by the manufacturer for "in-house transportation" for approximately 200 hours. Beechcraft also requires a payment of approximately \$60,000 from SRA. This payment is to reflect the difference in value between the 1982 Baron and the 1984 Baron. While the planes are almost identical in construction and equipment, market forces make the 1984 aircraft worth more. This transaction is not the result of any plan to upgrade taxpayer's equipment. It is designed only to replace defective merchandise.

Our questions are as follows,

- Will California Use Tax be imposed upon this transaction? If so,
- Will the tax be based upon the \$60,000 additional value of the 1984 Baron? or,
- Will the tax be based upon the full \$550,000 value of the 1984 Baron?
- If Beechcraft were required to replace the 1982 aircraft, as a result of a law suit filed by SRA, would use tax be due?
- Under what conditions would the replacement of the defective aircraft be a non-taxable transaction?

From the facts you relate, we infer that the value of a 1982 Baron is \$490,000. You do not say whether that is the value of a typical 1982 Baron, without defects, or the value of the defective 1982 Baron owned by S--- R--- & A--- (SRA). We will assume for purposes of this opinion that the value of SRA's defective aircraft is some amount significantly less than \$490,000, representing the loss in value attributable to the defect. This lesser amount is the trade-in value of the defective aircraft.

Based on the foregoing, our opinion is that SRA would be liable for use tax on this transaction measured by \$60,000 plus the trade-in value of the aircraft. This situation is governed by Sales and Use Tax Regulation 1655(b), which states:

- (b) DEFECTIVE MERCHANDISE. Amounts credited or refunded by sellers to consumers on account of defects in merchandise sold may be excluded from the amount on which tax was computed. If, however, defective merchandise is accepted as part payment for other merchandise and an additional allowance or credit is given on account of its defective condition, only the amount allowed or credited on account of defects may be excluded from taxable gross receipts. The amount allowed as the "trade-in" value must be included in the measure of tax.

Thus, the only amount which may be excluded from the \$550,000 sales price of the 1984 Baron is the amount which the seller allows or credits against the sales price on account of the defects in the 1982 Baron. If no allowance or credit were given on account of defects, no deduction could be taken against the sales price. Of course, the amount of the allowance or credit for the defect must be reasonable, and the taxpayer, SRA, is obligated to keep such records as are necessary to substantiate the allowance or credit. Revenue and Taxation Code sections 7053, 7054.

If SRA filed suit against Beechcraft, we do not think a California court would order Beechcraft to replace the airplane. Rather, the court would in all likelihood only order Beechcraft to pay damages to SRA based on the loss in value of the airplane attributable to the defect. Such an award of damages for the defect is not taxable. However, if for some reason a court did order Beechcraft to replace the airplane, then we would apply the provisions of Regulation 1655 to the terms of the judgment (or a stipulated settlement of the suit) in the same manner as the regulation would apply in the absence of a lawsuit.

In answer to your last question, regarding the conditions under which the replacement of the defective airplane would be a nontaxable transaction, we assume that what you are asking is whether there are any circumstances under which the trade-in value of the 1982 Baron would not be included in the measure of tax on the replacement aircraft.

Regulation 1655(a) provides in relevant part:

- (a) RETURNED MERCHANDISE. The amount upon which tax is computed does not include the amount charged for merchandise returned by customers if, (1) the full sale price, including that portion designated as "sales tax", is refunded either in cash or credit and (2) the customer, in order to obtain the refund or credit, is not required to purchase other property at a price greater than the amount charged for the property that is returned. Refund or credit of the entire amount is deemed to be given when the purchase price, less rehandling and restocking costs, is refunded or credited to the customer.

The conditions of this regulation would be met if Beechcraft both (a) credits SRA with the full original purchase price of the 1982 Baron, (\$460,000), plus tax reimbursement, and (b) either does not require SRA to purchase any replacement aircraft at all or requires SRA only to purchase a replacement aircraft equal to or below the value of the credit. In this event, while SRA's purchase of a replacement aircraft would be a taxable transaction, no additional tax would be due because Beechcraft would be entitled to take a returned merchandise credit on its next return, in the amount of \$460,000, fully offsetting the sales price of the replacement aircraft.

We do not think the facts you have outlined to us would entitle Beechcraft to take the returned merchandise credit, because we read those facts as including Beechcraft requiring SRA to purchase a more expensive (\$550,000) airplane. Beechcraft, however, could take the credit if SRA is merely electing, at its option, to purchase the more expensive airplane, and is not required to do so, and if Beechcraft gives SRA a credit for the full \$460,000 plus tax reimbursement. Then the additional tax due on the transaction would be measured by \$90,000, which represents the \$550,000 purchase price less the \$460,000 returned merchandise credit. In this case, the tax reimbursement already paid by SRA and credited to SRA by Beechcraft would be available as an offset against the tax due on the purchase of the more expensive aircraft.

S--- R--- & A---, Inc.

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Jan. 16, 1985  
490.0325

I enclose a copy of Regulation 1655 for your information. Please feel free to contact me if you have any further questions or comments about this letter.

Very truly yours,

John Abbott  
Tax Counsel

JA:ss

Enclosure